Submission

No 4

INQUIRY INTO FINANCIAL REPORTING

Organisation: Treasurer

Name: The Hon. Eric Roozenaal MLC

Position: Minister for State and Regional Development, Special Minister of State

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Theme:

Summary

NEW SOUTH WALES

TREASURER
MINISTER FOR STATE AND REGIONAL DEVELOPMENT
SPECIAL MINISTER OF STATE

RECEIVED
09 JUL 2010
PAC

Mr Paul Gibson
Chair
Public Accounts Committee
Parliament of New South Wales
Macquarie Street
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Contact: Mr Mark Pellowe
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Our Reference: D10/04496
Your Reference: PAC324

08 JUL 2010

Dear Mr Gibson

Inquiry into the quality and timeliness of financial reporting

I refer to your letter of 2 June 2010 seeking submissions to the Public Accounts Committee's Inquiry into the quality and timeliness of financial reporting.

I support the Committee's initiative to review this area and am pleased to attach my response.

Yours sincerely

THE HON ERIC ROOZENDAAL MLC

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Public Accounts Committee – Inquiry into Financial Reporting

Treasurer's Submission

Overview

The Committee is examining the quality and timeliness of financial reporting by NSW government departments and agencies. The review arose after the Auditor-General raised concerns regarding the quality of financial reporting in Volume Four of his 2009 Report on Financial Audits.

I welcome the review and the opportunity to demonstrate recent initiatives put in place to improve financial reporting.

It is important to place the findings of the Auditor-General within context. The majority of the reported misstatements in accounts submitted to the Auditor-General for audit relate to the valuation of assets and liabilities. These arose either because the agency had not finished the valuation exercise by the time the accounts were given to the Audit Office for audit or the Audit Office disagreed with the valuation provided. A smaller number of misstatements relate to incorrect application of accounting standards by agencies for specific transactions.

The errors noted by the Auditor-General mostly relate to discrete events, such as annual valuation exercises, and not systematic errors in management reporting.

The valuation of assets and liabilities is a more complex and subjective issue in the public sector compared with the private sector because:

- The public sector has substantial holdings of assets with very long lives. This requires the use of fair value accounting, which involves subjective judgements about existing use valuations, expected useful lives and residual values. The private sector usually adopts the objective historic cost valuation methodology; and

- The public sector must apply both Australian Accounting Standards and Government Finance Statistics principles, whereas the private sector only has to apply the former.

The misstatements noted by the Auditor-General are large, in absolute dollar terms, but are relatively small compared to the overall size of the Government's operations. The misstatements in the Total State accounts, as reported by the Auditor-General, are 0.3 per cent of revenues and 0.1 per cent of expenses.

None of the uncorrected misstatements reported by the Auditor-General resulted in an audit qualification. That is, all the uncorrected misstatements were considered immaterial in the Total State Accounts by the Auditor General.

Australian Accounting Standard AASB 1031, *Materiality*, defines material as follows:

> *Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.*

I do not wish to incur additional costs and reduce frontline service delivery on accounting processes that have no impact on economic decisions, i.e. have no additional benefits.

Nevertheless, as demonstrated below, NSW Treasury is working collaboratively with the NSW Audit Office to reduce the number of misstatements identified in the audit process on a benefit cost basis.

1. The adequacy of current processes in place to identify and correct errors in accounts in a timely manner

There is a range of procedures that agencies are required to have in place that should assist in identifying and correcting errors in accounts in a timely manner.

Agency management is required to provide periodic reports and explanations of variances to key stakeholders.

- General Government agencies provide financial statements to Treasury each month (from September) for the year to date and the latest full year projection. Treasury analysts review this data and will question any significant variances or other issues of interest. However it should be recognised that these estimates are unlikely to be subject to the same quality control afforded to annual accounts.

- Public Trading Enterprises (PTEs) must report regularly to their boards, many of whose members will have extensive private sector and industry experience. PTEs also provide financial statements through the Treasury system three times a year – for the Half Yearly Review (in November), State Budget (in April) and the Consolidated Financial Statements (in July). PTEs are also required to report financial information quarterly to shareholding Ministers.

A limitation of periodic reporting is that cyclical valuations of assets or liabilities is costly, and so cannot be performed monthly. As in the private sector, agencies adopt monthly accrual journals generally based on an emerging estimate, which is adjusted when a full valuation is performed.

Agency management is required to conduct early analysis and resolution of significant accounting issues prior to the financial year end. Agencies are required to report in May each year to the Audit Office and Treasury on significant emerging issues that may impact their financial report. This assists with the early review and resolution of issues prior to the preparation of the financial statements for the year ended 30 June.

Some agencies, in conjunction with the Audit Office, perform 'early substantiation' on key balances. This involves audit reviewing key risk areas such as bank balances and reconciliations, asset registers and valuations and review of new or amended accounting treatments. This early preparation and audit review is helpful in ensuring matters are considered by management and audit before year end, to avoid significant errors occurring in year end reports.

Historically, early substantiation has been voluntary. It is subject to the availability of agency and audit resources to perform the activity in the March and April period, which can clash with other work loads such as budget preparation and, for the Audit Office, the audit of universities (which have a December year end).

The weakness of early substantiation to date is that it is voluntary, and is selective, unlike a formal 'hard close' process. Current initiatives to implement more formal hard close processes are addressed under best practice procedures, below.

Agencies should conduct an internal review of financial reports, by management and or internal audit, before lodging reports with the Audit Office. The preparation of analytical review on the financial report, prior to lodgement, is important in ensuring a quality report. Some agencies employ internal auditors to review their financial report, to provide a higher level of assurance.

The ability of agencies to perform a full internal review for all notes to the accounts has been somewhat diminished over the years, as accounting standards have expanded with the adoption of international accounting standards to include more onerous disclosures. There is evidence that some agencies complete their reports to meet the statutory deadlines, but some note disclosures, such as income tax or financial instruments, are completed only after the accounts are lodged with audit. The first time preparation of a note disclosure, after lodgement with audit, can increase the risk of an error.

Treasury's Internal Audit and Risk Management Policy was issued in August 2009. While this was not issued in response to the Auditor-General's report, it is a significant reform that should help address some of the Auditor-General's concerns:

- The mandating of independent audit committees should strengthen the oversight within the agency of the production of the accounts. In particular, there should be a reduction in the delivery of incomplete accounts to the Audit Office for Audit; and

- Treasury is ensuring that Audit Committees are fully informed of initiatives in relation to improvements in financial reporting, to help them prioritise their work program.

2. Identification of best practice procedures for financial reporting

Most of the misstatements detected by the Auditor-General would potentially be resolved by the combination of the early hard close and stronger agency accountability for the quality of their financial information. The following initiatives should help to provide earlier as well as more accurate financial information.

Hard close

The response most likely to address the issue of misstatements is to introduce an early "hard close". This means that:

- Agencies provide the Audit Office with a complete full set of financial statements as at 31 March or 30 April, with all valuations complete and accounting policy issues resolved. This is far more extensive than the early substantiation procedures presently adopted by several agencies, as a hard close is effectively a full dry run of the report preparation process

- The Audit Office reviews these statements and any disagreements or other issues are resolved with the agency prior to 30 June

- Full financial statements for the Year ended 30 June are provided to the Audit Office after the year end. These statements reflect the resolution of any issues that arose from the Audit Office review of the March or April statements.

Treasury and the Audit Office are presently piloting elements of hard close procedures with 15 large agencies for 2009-10 year end. The specific steps to implement the pilot are as follows:

- On 22 December 2009, Treasury wrote to the Chief Finance Officers of key large agencies:

    - noting the concerns of the Auditor-General in Volume 4 that agency financial reports submitted to audit contained significant errors; and

    - proposing that key agencies and Treasury develop procedures to improve the quality, reliability and timeliness of financial reporting, specifically to move to early close and early audit review.

- On 17 February 2010, Treasury convened a round table of Chief Finance Officers, Audit Office and Treasury officials to discuss implementation of a hard close regime. The Department of Health provided advice, based on its early close procedures adopted in 2009.

- On 26 March 2010, Treasury issued Treasury Circular TC 10/02, 2009-10 *Total State Sector and General Government Sector Financial reports – Financial Reporting Requirements for Agencies.* The Circular promotes the implementation of a hard close process including:
  - For 2009-10 a group of 15 pilot agencies will trial elements of a hard close to assure accuracy and improve timeliness of audited financial reports.
  - The 15 pilot agencies are all from the group of 22 largest agencies.
  - These agencies provided implementation plans by 26 March 2010.
- In order to support early close, Treasury has undertaken to issue its accounting policy and reporting circulars earlier (by 30 March). Key documents issued this year were:
  - Treasury Circular TC 10/1: *Financial and Annual Reporting Implications of the July 2009 Agency Restructures* was issued on 19 March 2010
  - Treasury Circular TC 10/2: 2009-10 *Total State Sector and General Government Sector Financial Reports – Financial Reporting Requirements* was issued on 26 March 2010 (last year it was issued on 1 June 2009)
  - *The Financial Reporting Code for Budget Dependent: General Government Sector Agencies* was issued on 24 March 2010 (last year it was issued in May 2009)
- The Audit Committees of the pilot early close agencies were informed directly by Treasury of this initiative.
- The relevant agencies, Treasury and the Audit Office have agreed to meet in November 2010 to review the findings of the hard close pilot, with a view to widening the program across the public sector.

System certification

In April 2010, Treasury wrote to all agencies indicating that in March each year, as part of their annual Budget returns, Chief Finance Officers must attest that as at 31 March their agency "has effective systems, processes and internal controls to ensure that the monthly and annual financial information provided to Treasury is relevant and reliable."

This certification process will start in March 2011, in order to allow sufficient time for agency Audit and Risk Committees to ensure that systems, processes and internal controls are in place to support the required certification. Audit Committees have been informed of this initiative.

Earlier Reporting

Earlier reporting deadlines are important to enhance accountability for financial performance. They will also create incentives for agencies to adopt different financial reporting processes, such as a hard close or early substantiation. The current statutory reporting deadlines for NSW departments and PTEs are

- 11 August - agencies lodge financial report with Audit
- 20 October – sign off financial report
- 30 November table annual report in Parliament.

These deadlines for NSW government agencies have not been updated for many years. In the meantime, other states and the private sector have been gradually shortening reporting deadlines.

The other large state governments do not generally have three statutory deadlines for agencies, but operate in a more flexible environment to meet a statutory tabling deadline generally at the end of September or October.

The urgency of achieving a tighter deadline, such as tabling annual reports by say 30 September instead of 30 November for New South Wales, would result in agencies and audit having to streamline and bring forward their year end processes through early substantiation, or a 'hard close'. Such a significant change would be expected to take more than one year for NSW agencies to implement.

The preparation of consolidated whole-of-government reports is dependent upon the timely and accurate preparation of agency financial reports. The following table shows the date that audit signed the 2010 Independent Audit Reports for the State Accounts for each jurisdiction:

Jurisdiction	Timing
New South Wales	22 October
Victoria	29 September
Queensland	20 October
Western Australia	22 September
South Australia (Audit Review Letter)	16 December
Tasmania	28 October
Australian Capital Territory	30 October
Northern Territory	14 October

Professionally qualified staff

Agencies are required to prepare annual financial reports in accordance with Australian Accounting Standards and Treasury policies. Government agencies have significant budgets, and operate in a variety of industries, each with their own complexities. The application of accounting standards requires that a professional accountant oversight and prepare the financial report.

Many agencies employ qualified chartered accountants and CPAs as Chief Finance Officers and report preparers, but there is presently no government requirement to employ such qualified accountants.

The employment of qualified accountants (i.e. full members of the Institute of Chartered Accountants in Australia or CPA Australia) as Chief Finance Officers, could raise the knowledge and skill level for the person ultimately responsible for financial report preparation.

3. Impediments to the implementation of best practice procedures

The current hard close pilot will identify specific impediments to the implementation of best practice, as well as potential strategies to overcome those impediments. At this stage, it may be anticipated that impediments will include:

- Practical difficulties in scheduling valuation exercises in March or April
- Availability of agency finance staff because they may be engaged on State Budget and internal budgeting matters
- Availability of Audit Office staff because they may be involved in performing university audits during March and April, which could affect the Audit Office's ability to review and provide timely feedback on information provided by the agency as part of the hard close regime
- Valuation exercises which can only be done sensibly at year end, for example superannuation liabilities that depend on current market rates.
- Higher audit cost for agencies to perform a hard close. Very small agencies are much quicker to audit, so reviewing a hard close and a final report may not be cost beneficial.

Treasury's research indicates that other Australian governments do not mandate hard close procedures. However, many of these jurisdictions have some agencies that perform hard closes, as a tool to provide greater assurance to management (and audit), and towards meeting their earlier statutory deadlines.

Treasury will use the experience of the NSW pilot and experience in other jurisdictions to develop the most cost beneficial and practical approach to year end reporting and auditing procedures.